Tax News Special Feature: Abusive Tax Schemes

Article #2 (July 2003)

The State cracks down on abusive tax schemes

This article is the second in our series on abusive tax schemes

The California legislature has proposed two bills aimed at discouraging investment in abusive tax schemes and providing the state with more tools to combat the behavior.

Senate Bill 614 mirrors federal proposed legislation by creating broader reporting and disclosure requirements and new, costlier penalties that increase the risks associated with playing audit roulette. Assembly Bill 1601 proposes to increase existing tax shelter penalties. Both bills extend the amount of time California has to issue deficiency notices for tax shelters from four years to eight years.

Some of the proposed penalties in SB 614 will apply to tax years beginning in 1999. The extension of time to issue a deficiency notice will also apply to tax years beginning in 1999. These tools are necessary to crack down on abusive tax schemes now, not just to deter future investments in these schemes.

We have received some inquiries regarding options available to taxpayers who are reconsidering their use of tax avoidance schemes to understate their tax liabilities. Your clients can amend their state income tax return at any time to restate their proper tax liability. Payment of their self-assessed tax and appropriate interest is due when they file their amended return. The accuracy related penalty is applicable to many abusive tax schemes, however your client may avoid this penalty by filing a *qualified amended return* (for that taxable year) as provided in Treasury Regulation Section 1.6664-2(c).

Timing is critical. Inform your clients that in order to avoid our accuracy related penalty we must receive the qualified amended return before we or the Internal Revenue Service contacts them about the return; otherwise they are ineligible to file a qualified amended return and remain subject to penalties.

If any of your clients are interested in filing a qualified amended return, please use the address below. To ensure proper handling, identify the return as *QAR TS* in the top right margin of the first page.

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Article #1 (May 2003)

Steer clear of abusive tax schemes

This article is the first in our series on abusive tax scheme transactions.

In recent years, individuals and business entities have increasingly taken advantage of abusive tax schemes.

The Internal Revenue Service defines abusive tax schemes as transactions promoted for the promise of tax benefits with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets.

These transactions typically have no economic purpose other than reducing taxes, and most involve the use of multiple layers of domestic and foreign pass-through entities including: partnerships, S corporations, limited liability companies, and trusts.
Another common abusive tax scheme uses offshore banks that issue debit/credit cards. The IRS is vigorously pursuing taxpayers investing in apparent abusive tax schemes. They are focusing on tax return preparers and the promoters of these investment schemes, and are pursuing penalties and criminal prosecution for these cases.

The IRS also has had limited compliance initiatives for certain abusive tax schemes that encouraged taxpayers to voluntarily come into compliance with the federal tax law and file amended returns before the IRS contacted them for an audit. As a result of these compliance initiatives the IRS was able to obtain the names of promoters and tax preparers involved in the marketing of abusive tax schemes, as well as the names of taxpayers investing in these schemes. Information received from the first initiative alone resulted in the disclosure of deductions totaling $30 billion.
For additional information on IRS activity on abusive tax schemes and numerous notices and announcements focusing on tax shelters, log onto their Website at www.irs.gov/businesses/corporations.

We are stepping up our audit activities on taxpayers investing in abusive tax schemes and working closely with the IRS to identify taxpayers, perform audits, and uncover abusive tax scheme transactions.

We've identified, for audit, tax returns reporting approximately $4 billion in losses and we are also holding on to many tax returns pending the completion of the IRS' audits. Congress is considering legislation aimed at deterring or discouraging investment in abusive tax schemes.

Some of the proposed provisions include:

- Extending the period for issuing a federal deficiency notice for abusive tax scheme losses from three to six years, to allow the IRS more time to identify and address abusive tax schemes.
- Imposing penalties equal to 40 percent of the tax liability attributed to the abusive tax scheme for taxpayers investing in abusive tax schemes.
- Imposing penalties up to $200,000 on taxpayers who do not disclose their investment in an abusive tax scheme on their return.
- Imposing penalties of up to 100 percent of the gross income earned in the marketing of the abusive tax scheme on the promoters.

The California legislature is also considering law changes to address abusive tax schemes, including considering the proposed federal legislation